



# TASK FORCE REPORT



# BEGINNING THE

# JOURNEY

# CHINA, THE UNITED STATES, AND THE WTO

REPORT OF AN INDEPENDENT TASK FORCE  
SPONSORED BY THE COUNCIL ON FOREIGN RELATIONS

ROBERT D. HORMATS, CHAIR  
ELIZABETH ECONOMY AND  
KEVIN NEALER, PROJECT DIRECTORS

# Beginning the Journey China, the United States, and the WTO

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*Report of an Independent Task Force  
Sponsored by the  
Council on Foreign Relations*

Robert D. Hormats, Chair  
Elizabeth Economy and  
Kevin Nealer, Project Directors

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## FOREWORD

In 1999, the Council on Foreign Relations organized an Independent Task Force to examine U.S. economic relations with China within the context of the overall bilateral relationship. Over the past two years, the Task Force has met periodically to track developments in China's economy and to assess their implications for U.S. interests. During this period, the Task Force members benefited enormously from presentations by scholars, officials, and business people, including Ray Bracy, Nicholas R. Lardy, Barry Naughton, Edward S. Steinfield, Kenneth Lieberthal, Douglas Bereuter, Deborah M. Lehr, Lyric Hughes, and George Vradenburg.

In early 2001, with China's entry into the World Trade Organization (WTO) virtually assured, the Task Force determined that the process of China's transition into the WTO raised a number of new and pressing issues for America's policy toward China. Chief among these was ensuring that U.S. policymakers take advantage of the opportunities presented by China's WTO entry to make progress on the full range of U.S. economic, political, and security interests.

This Task Force Report notes that without a concentrated and coordinated effort among the executive branch, Congress, and the private sector, short-term difficulties in China's implementation of its WTO commitments will likely undermine long-term cooperation with the PRC. The report outlines in some detail the social, economic, and political challenges Chinese authorities will face in implementing their part of the bargain. The Task Force also underscores the high—perhaps unrealistically so—expectations of many Americans concerning the benefits that will accrue to the U.S. economy in the immediate aftermath of China's entry into the WTO.

In response, the Task Force recommends that U.S. and Chinese actors, from both private and public sectors, take a number of proactive measures. These include, most immediately,

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targeting a few high-profile WTO commitments for early implementation to build mutual confidence, and supporting through financial and technical assistance China's overall efforts to develop market-based rules. By taking these and other steps, the Task Force argues persuasively, the United States has the best chance not only to shape the future of Sino-American economic relations but also to foster better cooperation on other key areas of U.S. political and security concern.

I am very grateful to Robert D. Hormats for soundly guiding this important endeavor and to Council Senior Fellow Elizabeth Economy and the Forum for International Policy Senior Fellow Kevin Nealer, project directors, who were ably assisted by the Council's China Studies Research Associate Eric B. Aldrich. Glen Goldman and our Washington office were integral to the success of the Task Force, providing expert communications support for each of the sessions. I also want to thank the Arthur Ross Foundation for providing funding for this Task Force.

*Leslie H. Gelp*  
President  
Council on Foreign Relations

## EXECUTIVE SUMMARY

In coming years, the character of Sino-American relations may be shaped as much by the management of trade and economic issues as by traditional security concerns. The People's Republic of China (PRC) is already the world's seventh-largest trading power, with annual two-way trade of over \$475 billion and almost \$120 billion in bilateral trade with the United States (see Appendix 1). The trade and investment aspects of Sino-American relations are fundamentally and critically important to China's national interests, most especially to its top priority of modernization. For the United States, increasing trade and investment with China brings not only the potential for enormous economic gains but also the opportunity to advance cooperation with China on the full range of U.S. political, economic, and security interests.

China's World Trade Organization (WTO) entry marks a new stage in its economic reforms and in its relations with the rest of the world (see chart on page 2). China's transition to this next stage, however, poses significant challenges for both China and the United States.

For China's leaders, chief among these challenges is the tension between their desire to maintain the leadership of the Chinese Communist Party and the social and political pressures arising from continued economic reform. Transforming China's society to one based on the rule of law will also be difficult and time-consuming. Moreover, growing social dislocation and unrest will test Beijing's resolve to move forward with economic reform.

For the United States, the greatest risk is that short-term difficulties and unevenness in the implementation of China's commitments to the WTO will undermine rather than support Washington's goal of fostering long-term cooperation with the PRC. All this will be taking place alongside the cooperation the United States seeks from China in combating terrorist activities emanating from Afghanistan and other parts of the world.

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**Chart 1. KEY CHANGES CHINA HAS PROMISED AFTER IT JOINS THE WTO**

<b>AGRICULTURE</b>	<b>AUTOMOBILES</b>	<b>BANKING</b>	<b>DISTRIBUTION/ RETAIL</b>
<ul style="list-style-type: none"> <li>Future farm subsidies will be capped at 8.5% of the value of domestic farm production</li> <li>Agricultural duties will fall from 22% to 17%</li> </ul>	<ul style="list-style-type: none"> <li>Import tariffs on automobiles will drop to 25% by mid-2006 from the current 80-100%</li> <li>Restrictions will be lifted on category, type, and model of vehicles produced as joint ventures</li> </ul>	<ul style="list-style-type: none"> <li>Foreign banks will be allowed to conduct domestic currency business with Chinese firms and individuals in phases</li> <li>All geographic restrictions on foreign banking business will be eliminated after five years</li> </ul>	<ul style="list-style-type: none"> <li>Restrictions on distribution services for most products will be phased out within three years</li> </ul>
<b>ENERGY/OIL</b> <ul style="list-style-type: none"> <li>Crude and refined oil sectors will be gradually opened to private traders</li> <li>Retail oil distribution will open in three years</li> </ul>	<b>INSURANCE</b> <ul style="list-style-type: none"> <li>Increased foreign ownership of life, property, and casualty insurance operations will be allowed*</li> <li>Foreign insurance companies will gradually enter group, health, and pensions businesses</li> </ul>	<b>SECURITIES</b> <ul style="list-style-type: none"> <li>Minority foreign-owned joint ventures will be allowed into fund management industry</li> <li>Three years after accession, foreign firms will be allowed 49% stakes in joint ventures</li> </ul>	<b>TELECOMMUNICATIONS</b> <ul style="list-style-type: none"> <li>Foreign companies can take increased stakes in mobile phone companies in phases</li> <li>Tariffs on high-tech products will be eliminated by 2005**</li> </ul>

Source: "Key Changes China Has Promised after It Joins the WTO," *Wall Street Journal*, September 17, 2001, p. 1.

\*The level of foreign companies' ownership in insurance operations will not increase; rather, the number of cities in which they are permitted to operate will increase.

\*\*The phase-out in tariffs on high-tech products does not actually apply to telecoms; rather, the phase-out applies to semiconductors, computers, and other products associated with information-technology associated products.

This Task Force Report offers Americans inside and outside government a way of thinking about the significant opportunities created by China's membership in the WTO as well as the considerable challenges it poses. While this report discusses many of the things that could go wrong during the transition period within which China implements its commitments to the WTO, our

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primary goal is to address the many ways in which cooperation between the United States and China can improve prospects that things will go right. A realistic, determined, and supportive approach by the United States to WTO implementation now and in the medium term can do more to shape China's economic and, perhaps, broader political priorities than any policy choice in almost thirty years of bilateral relations. Accordingly, this analysis recommends a strategic approach to China's participation, incorporating the following actions:

- Support China's overall efforts to develop market-based rules and to continue to adapt its institutions and practices—at the national and local levels—to the challenges of globalization. This will produce enormous benefits not only for China but also for the global economy.
- Build mutual confidence with an agreed agenda of “early harvest” accomplishments in key sectors, such as agriculture and information technology.
- Remove the remaining impediments to the renewal of U.S. trade and technical assistance to China from U.S. government agencies and programs, including the Overseas Private Investment Corporation (OPIC) and the U.S.-Asia Environmental Partnership (USAEP).
- Develop alternative venues that can be used for dispute resolution from time to time—utilizing either preexisting bilateral meetings or an entirely new structure—to avoid overloading the WTO process.
- Foster private-sector financial and technical support for China's efforts to develop the market-based rules, institutions, and expertise—at both the national and the regional level—necessary for effective WTO compliance.
- Stress multilateral efforts to encourage a culture of compliance within China in order to avoid the United States' being the sole demander. In so doing, recognize that because multilateral rules will apply to Sino-American trade, there will be differences of

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opinion in which, on occasion, the WTO might rule in favor of China. That WTO decisions can go against the United States is a reality to which we have become accustomed in our trade relations with other countries.

- Develop a congressional–private sector partnership to ensure active oversight of China’s WTO compliance in ways that ultimately strengthen Sino-American relations.

Key to U.S. strategy toward China is the further development of the broader bilateral economic, financial, and investment relationship. Close cooperation between the United States and China in the WTO is a central element of that relationship. It must be a high U.S. policy priority to help ensure a smooth and successful transition both within China and between China and the international economic community. This Task Force believes that such an approach will make it easier not only to resolve mutual trade disputes but also to foster better cooperation in other areas, such as security. We recognize that the coming transitional stage is likely to be difficult. China’s membership will test the multi-lateral system in ways that require both persistence and creative policies to deliver real results. This report offers a starting point for such policies.

## TASK FORCE REPORT

### INTRODUCTION

U.S. relations with China present formidable policy challenges under the best of circumstances. Since the 1989 Tiananmen tragedy and the end of the Cold War, the economic component of U.S.-China relations is one of the few strands in the overall relationship that has not strained close to the breaking point.

Recent tensions in the relationship over the arrests of scholars and differences in policies toward Taiwan are emblematic of the persisting stresses in Sino-American relations. This reality will place an even brighter political spotlight on the way China's entrance into the World Trade Organization (WTO) is handled by both China and the United States. A successful transition to the WTO regime will be an important benchmark for China in its dealings with the outside world. It also could be a powerful underpinning for a broadly cooperative U.S. relationship with China. At the same time, failure to manage this transition adequately could have profound implications for the WTO as well as for U.S.-China relations.

Dynamic Chinese economic growth has made it the world's seventh-largest trading power, with some \$475 billion in annual two-way trade. Entry into the WTO offers China the opportunity to sustain its growth and increase its trade, dramatically advancing the restructuring of its economy and the competitiveness of its industries and services. It presents the opportunity for the United States and other nations to support and encourage the economic transformation of the world's most important emerging economy and substantially strengthen the global architecture of rules-based, market-oriented trade. At the same time, of course, China's entry into the WTO creates formidable policy challenges and risks for China, the United States, and the trading system.

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After nearly fifteen years of often uncertain negotiations, China and other major trading nations have reached agreement on a set of commitments that will shape China's economic policy and its course of development for years to come. The implementation of these obligations will transform China and U.S.-China economic relations. For China it will require the enactment and implementation of an enormous number of new laws and regulations. It will also require the will and ability of tens of thousands of officials—in Beijing and in the provinces—to enforce these laws and regulations and of tens of thousands of businesses to comply with them. It will unleash a wave of new competitive pressures that will not only deepen reforms in businesses at many levels and in many parts of the country but will also heighten the potential for an increase in the already significant level of social unrest that the government confronts.

For the United States, China's entrance into the WTO will give rise to an ongoing domestic debate over the degree to which China is faithfully implementing its commitments and how much American companies and the United States as a whole are benefiting from the changes taking place. One particularly difficult challenge would emerge if unemployment and associated social unrest in China were to increase significantly, causing Beijing to slow or halt implementation of some of its WTO commitments.

In many ways, the entry of China—and that of Taiwan—presents unparalleled challenges to a WTO system already under stress from an ambitious new agenda and a threefold increase in dispute-settlement cases. As WTO members contemplate the next steps in multilateral trade liberalization, it will be essential to understand that China's participation in the WTO will have a considerable influence on the agenda of any future WTO-centered round of trade negotiations. China's membership in the WTO will give it an opportunity to shape the future of the WTO and the future of the global economic system as never before. It is in U.S. interests to work closely with China to develop as much commonality of goals and expectations as possible in this process.

Foreigners delight in recognizing that the Chinese character for “crisis” consists of the combined words for “opportunity” and

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“danger.” Expectations about the economic and political opportunities created by China’s WTO participation are high—perhaps unrealistically so. U.S. corporations made passage of legislation providing China with permanent normal trade relations (PNTR) status (once it joins the WTO) one of their top political priorities in 2000. China’s growth in the past decade exceeded 340 percent, with the country absorbing one out of every three direct investment dollars going to the developing world. Enormous gains have been made in transforming China’s state economy, through reducing the role of state-owned enterprises while encouraging collective and private-sector growth, and opening the economy to foreign participation (see Table 1 below).

**Table 1. Share of Gross Output Value of Chinese Industrial Enterprises**

	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
<b>State-Owned</b>	47%	37%	34%	36%	32%	28%	28%
<b>Collectives</b>	34%	38%	37%	39%	38%	38%	35%
<b>Individually Owned</b>	8%	10%	13%	15%	18%	17%	18%
<b>Other</b>	11%	15%	17%	17%	18%	23%	26%
<b>Total</b>	100%	100%	100%	100%	100%	100%	100%

*Source:* Harry Broadman, “The Business(es) of the Chinese State,” *The World Economy*, Volume 24, Number 7, July 2001.

*Note:* The shares data do not sum to 100 percent due to rounding and statistical changes in the authorities’ reporting tables.

But tensions over political issues centered on Taiwan, human rights, and nonproliferation remain. These issues polarize political views in both the United States and China and encourage hard-line attitudes in each country. Policymakers on both sides will continue to confront the question of whether it is possible to sustain an ambiguous relationship in which the two countries cooperate on commercial and financial matters while simultaneously experiencing tensions on a range of political, values-oriented, and security questions.

### CHINA’S WTO ENTRY: IMPLICATIONS BEYOND THE ECONOMY

The Sino-American dialogue on issues ranging from human rights to security issues has often been contentious and even con-

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frontational. By contrast, for more than two decades, a generally consistent set of mutual economic interests has driven commercial relationships, which have developed in a relatively orderly and predictable way. Economic relationships have forged a growing sense of mutual understanding among government authorities and private-sector participants about what is possible between the two countries. They have created a culture of pragmatic cooperation that includes not just officials in Beijing but also a host of public-sector and business leaders in the provinces.

These shared interests in economic ties have in no small measure sustained the U.S.-China relationship. This emphasis on basic economic interests has engendered criticism that economic diplomacy has led to a soft-pedaling of the U.S. political and security agenda. But trade and investment can, and do, support broader American foreign policy goals. They do so by reinforcing the bet that Beijing's leadership has made on globalization and on China's incorporation into the global community. This engagement with the international community has tended to foster greater openness in Chinese society as China increasingly (although not necessarily smoothly or in a straight-line progression) adjusts its economic policies, as well as its social and political structures, to the demands of a more market-driven world economy and to the kinds of business practices that globalization entails.

As China prospers from its increasing integration into the global economy, its authorities may recognize that prosperity will create additional demands for political pluralism and that consumer choice will translate into an urge for other choices. To date, Beijing has been largely unwilling to accept the emergence of strong independent forces outside the control of the state or the Communist Party. As continued economic growth produces a larger middle class and a greatly expanded private sector, the quality and quantity of forces outside the domain of the state will grow substantially. Beijing will be increasingly challenged to accommodate more elements of civil society and to meet the rising expectations of these new social forces. More immediately, China's leaders recognize that the success or failure of the government now depends heavily upon their ability to continue to deliver sustained high growth, low infla-

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tion, more jobs, and visible improvements in the lives of urban and rural citizens.

Beyond the sociopolitical implications of China's continued economic reform, there is no doubt that the country's military benefits from a more robust economy in the broad sense of possessing the resources to devote to building more capable armed forces. But there is scant evidence that trade with China has meant a one-to-one correlation with improvements in military capabilities. China is modernizing its military, along with the rest of its society, with a focus on high technology, and will continue to do so. However, it must also be said that China's concept of "comprehensive national strength" (as measured in economics, science, and technology, as well as in military strength) reflects the reality that Beijing attaches top priority to economic modernization. The United States maintains control over certain military-related technological exports to China. But apart from that, it is difficult to argue that, absent U.S. economic engagement, China's military modernization would be substantially diminished if there were a reduction of trade or economic engagement with the United States.

### CHINA'S WTO ENTRY: IMPLICATIONS FOR THE ECONOMY

With nearly fifteen years of trade negotiations completed, now comes the hard part. China and the United States are entering a new phase in their trade relationship. The formerly bilateral focus of the relationship will give way to a primarily multilateral one. More issues will be considered in the context of the WTO, and more interests will be asserted within the context of global trade rules, obligations, and procedures.

For over a decade, debate in the United States over the U.S.-China economic relationship was energized by the predictable, ritualized combat over annual legislation extending most-favored-nation (MFN) treatment. Since 1989, the outcome of that debate has rarely been in doubt. But the battle gave critics and supporters of bilateral relations a focus for their energies, and the votes around MFN bounded the larger China debate. Permanent normal trade

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relations exchanges the relative certainty that the annual debate provided for a new set of challenges to the U.S.-China relationship—economic and otherwise. In addition, the American pro-trade community is in some cases likely to shift from trade advocacy and support for a healthy overall relationship with China to an insistence on implementation of its WTO objectives. Domestic political pressures in the United States are likely to rise if tangible benefits in the form of U.S. jobs and exports do not emerge relatively early on in China's post-WTO accession period.

In China, the leadership is relying on the WTO to drive those politically more intractable policy challenges that remain after several years of economic reforms, especially with respect to improving the competitiveness of state-owned enterprises (SOEs). China's leaders know that the next phase of reform will be more difficult than the last, will increase the magnitude of short-term social dislocation, and yet is necessary to advance their modernization goals. They hope to accomplish this while reaffirming the central government's power over provincial and local authorities.

China will confront several types of problems when it begins to cope with the impact of its WTO commitments. In the first half of 2001, China enjoyed an official growth rate of approximately 8 percent. That growth rate, however, required heavy government spending to offset a substantial slowdown in the rate of growth of exports. China's near-term economic outlook offers a mixed picture. More than 6.5 million urban workers lost their jobs in 1999; some 2 million more became unemployed through mid-2000. (China does not publish numbers for rural unemployment.) Even without WTO strictures, state-owned enterprises face an ambitious agenda of reforms. With the foreign competition introduced by the WTO, those 40 percent of SOEs that do not generate profits will likely face rapid consolidation and the uncharted realm of restructuring or bankruptcy.

Moreover, until now, much of the cleanup of China's financial sector has been deferred. Some institutions have addressed this problem head on, but for others massive capital infusions and expansive fiscal policies have reduced the need to attack effectively the problem of loans to unprofitable state enterprises. With WTO

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disciplines, the increased participation of foreign firms will accelerate the need for genuine transparency, improved credit standards, and greater accountability for debts. Also, China's hopes of selling off SOEs have been hobbled by contractions in American, European, and Japanese equity markets.

It is unrealistic to imagine that China's transitional economy and its state-planning apparatus will easily surrender all aspects of its price, labor, and distribution controls covered by the WTO agreement to the uncertainties of foreign competition—especially in the time frames agreed to in the accession negotiations. Chinese planners are acutely aware that the country has relatively few international brand-name companies. They take considerable satisfaction in progress made during the past two decades in building up the domestic position of homegrown firms, especially in linchpin industries. But the reality remains that broad and deep competition from imports will put new pressures on state enterprises and traditional business arrangements. These challenges would occur even without WTO disciplines. With them, the problems will run deeper. The dividends to Chinese consumers in the form of increased choice and lower prices will be criticized by some as being of questionable value to an economy only beginning to emerge from protracted deflation.

Why did China's leaders take on the challenge of the WTO at such a moment? Because they understood that the major reforms generated by compliance with the rules of the WTO, along with the added commercial opportunities it provided, were critical to sustaining China's growth and economic dynamism. They also recognized that there is no perfect time for a planned economy to force on itself the tough adjustment measures necessary to achieve the kinds of reforms China requires. But the depth and vitality of China's economy encourage the belief that sooner is better than later, especially given the leadership changes the country faces during 2002–2003. Once a decision as important as seeking WTO membership is taken at the highest levels of the Chinese government, it is possible to make significant policy changes. Changing an established course in some sectors and regions of the country, however, will be very difficult.

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### UNDERSTANDING THE RISKS OF WTO IMPLEMENTATION

Where does this leave Sino-U.S. trade relations? American firms and workers—facing a bilateral trade deficit exceeding \$80 billion in 2000—expect to reap substantial benefits from expanding trade with, and investment in, China. And Chinese officials now face the tasks of managing the formidable structural and procedural challenges of WTO compliance, in addition to implementing ongoing state-enterprise reforms and creating meaningful social security protections. All of these concerns highlight the need for China's major trading partners—and the United States in particular—to address the challenge of China's WTO implementation with a well-considered strategy that reflects their own trade interests and supports the longer-term goals of fostering continuing economic reform in China.

Given the challenges it faces, it would not be surprising were China to fall short on some facets of WTO implementation. The agenda before it is formidable. In a period of roughly five years, China has pledged to lower tariffs sharply on large numbers of manufactured goods and farm products, engage in substantial agricultural trade liberalization, eliminate nontariff barriers in key industrial sectors, and open up service sectors such as banking and insurance. China has already made significant progress in some of these areas (see Appendix 2). Sensitive Chinese sectors, such as agriculture, are sure to present problems. Resistance from corporations, provincial governments, and some ministries is highly likely. There will be enormous macroeconomic benefits resulting from a more efficient allocation of capital and human resources and increased investment in the most productive parts of the economy. But these benefits will be diffuse, while the adjustment required of weaker sectors will be concentrated. Those facing short-term pain are well aware of it and will surely draw much of the domestic political attention and generate the most resistance.

On the other side of the Pacific, the possibility of rapid growth in imports from the most efficient sectors of the Chinese economy and large annual trade imbalances will challenge American policymakers. They will be under pressure from some groups to

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take a tough line on imports from China. They will need to recognize that being too tough could undermine support for further reforms in Beijing and could also weaken cooperation on broad foreign policy and security issues. But not being assertive enough could strengthen the hands of those in China who do not want to implement parts of the agreement while also strengthening protectionist forces in the United States. It will be important to pick the right issues on which to press the hardest regarding implementation of the WTO agreement, and to recognize that enforcement will no longer depend only on bilateral pressure but also will involve other WTO members (which could either facilitate or slow the process, depending on how effectively WTO procedures operate). Both American and Chinese policymakers must be prepared to put more energy into building examples of success rather than focus on shortcomings or allow them to occur in the first place.

Given the enormous significance of China's smooth transition into the WTO, it is important also to recognize the risks for all parties of possible difficulties or perturbations in the process. We cite these not because we forecast that they will occur, but because we believe that understanding them better will provide the necessary incentives and warnings so that the kinds of problems they raise can be avoided.

- *Systemic Risk:* Previous WTO experiences with nonmarket economies such as Poland share the significance of insignificance: they are not useful models because they do not inform judgments about coping with an economy of the size and complexity of China's. Nonmarket members of the General Agreement on Tariffs and Trade (GATT) or the WTO to date have had trivial external sectors and presented trading partners with limited import sensitivities. By contrast, the enormous volume of China's exports and imports and the country's expanding impact on global capital markets—both as an investment destination and a source of equity and debt offerings—assure that Chinese participation will test the WTO regime's flexibility. By taking on the challenge of integrating China into the WTO at a moment when emerging economies—and

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some in the developed world too—are questioning the benefits of the global trading system, getting China wrong could be the last mistake the WTO makes. Given the formative role that market-oriented world trade—supported and facilitated by GATT and now the WTO—has played in global economic growth, the potential risk of a WTO stymied by stresses as the result of China’s membership should be given considerable weight.

- *U.S. Risk:* Trade and investment have long served as perhaps the most important and most stable sources of cooperation between China and the United States. If China’s WTO implementation runs into serious obstacles, not only the economic relationship but also other aspects of the Sino-American relationship more broadly might be in jeopardy. The United States could lose one of the key organizing principles in the management of the bilateral relationship. Most likely, however, any breakdown would not be a complete one, and the response from the United States would therefore be nuanced—characterized more by frustration and friction than by a dramatic rupture in trade relations.
- *Chinese Risk:* Arguably, an outright inability to implement a large portion of WTO rules and obligations would be an enormous setback for overall Chinese economic and, possibly, political reform. This is not an outcome we expect, but it is one that some observers see as at least a possibility—a worst-case scenario. Such a situation would put at risk both the people and the policies responsible for China’s remarkable economic success in the past decade. If it were to be the result of a reaction to rising unemployment in China, it could also result in increased xenophobia and scapegoating of reformers and foreigners alike, with the attendant risk of an abrupt decline in foreign investment.

Thus, serious shortcomings would engender serious consequences. Significant erosion of China’s WTO commitments would result in more than just another cyclical downturn in relations; it could erode a key element of the domestic consensus in

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the United States that supports close U.S.-China relations. To many in the business community, support for a closer relationship with China depends upon its reinforcing demonstrable mutual economic advantages. If this does not occur, proponents of open trade with China will be put in a defensive position in domestic policy debates. Chinese imports, currently the source of relatively limited domestic sensitivities, could experience a backlash akin to the American response to Japanese products in the early 1980s.

Moreover, the U.S. debate about relations with China would be increasingly characterized by expressions of lost confidence, amid accusations that China's reform-minded leadership could not give life to its most important policy commitments. This could result in a period of reduced enthusiasm by the foreign business community and greater attention to the pursuit of investment and trade alternatives to China. Cooperation on a host of shared interests—from North Korea to environmental issues—could be influenced by those who might seize on trade frictions to raise or reinforce their pre-existing doubts.

Finally, for China, this first phase of implementation comes at a challenging time. During 2002–2003, the country will be going through a significant transition in senior leadership. The ascendance or influence of a number of the next generation of reformers could be threatened if domestic resistance to WTO implementation becomes retail politics in the hands of antireform forces. The relations between Beijing and the provinces would be further undermined if WTO gains were submerged in controversy. Without the WTO, there is currently no “next new thing” in China's economic future. The price of a major WTO disappointment could be paid in slower economic growth or, in the worst case, economic contraction.

### THE CHALLENGES OF WTO IMPLEMENTATION

That China's WTO compliance is likely to be difficult and uneven should come as no surprise to veteran observers of international trade. After all, the process of creating a single market in the Euro-

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pean Union has frequently missed its preset timetables. It has been characterized by fits and starts, uneven implementation, pockets of significant resistance, and often long-delayed implementation in key areas.

It is in no one's interest to declare China's transition a failure should it encounter the inevitable and predictable trouble spots. The challenge will be to work with Chinese government officials and opinion leaders to move the education and implementation effort along as quickly as possible. The WTO—and U.S. government and private-sector actors—must avoid becoming involved in Chinese internal politics, while helping Chinese officials to fulfill their WTO commitments on the basis of the agreed timetable—or as close to it as possible. This will require understanding the likely areas of difficulty in China's implementation effort:

- *Ownership of WTO implementation is narrow and does not include many ministries and provincial agencies.* The danger exists that some industrial ministries and elements of the central planning apparatus will introduce new industrial policies to counter some changes that would otherwise take place under the WTO in order to buy time for sensitive domestic sectors to become more competitive (e.g., new cellular telecom investment restrictions). Some of these policies might not be WTO violations, but they could compromise the spirit of China's WTO commitments.
- *China has yet to develop an adequate social safety net.* Nowhere is the need for transitional programs more profound than in rural areas, where SOE reforms and agricultural imports will increase competitive pressures. Seven out of ten Chinese live outside the urban centers. The dramatic increase in incidents of civil disturbances over the past three years indicates that the system faces serious and growing stress. These problems will almost certainly be exacerbated by the consequences of China's WTO accession. At the same time, a growing Chinese middle class will likely place new social and political demands on the government. Accommodating more independent and influential actors, as part of an independent civil society in areas such as agriculture, labor, and the legal system, will be a key

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challenge. Coping with both the rising expectations of the middle class and rising unemployment and declining wages in the countryside and among urban SOE workers, therefore, will be the crucial tests for the government.

- *China's administrative and enforcement capacity to ensure WTO implementation remains insufficient.* WTO implementation requires changes in, and enforcement of, more than 1,000 Chinese laws, regulations, and administrative guidances. Just publishing and distributing this volume of new law is a terrific challenge. China's court system is unaccustomed and ill-suited to hearing challenges to existing laws and regulations. Not only do many provincial Chinese judicial/administrative authorities often find themselves unaware of changes in law and policy for considerable periods of time after the changes are made but also the system itself presents barriers to reforms of laws and administrative guidelines. And huge numbers of officials will have to be educated in all of these new laws and regulations—a process now well underway but a daunting one for a country the size of China.
- *China's legal system is already under significant stress as it attempts to address systemic corruption.* WTO implementation occurs in the midst of charges of corruption unprecedented since the 1949 revolution. This has put both party and state institutions under substantial stress and could divert energies and personnel that otherwise might be devoted to WTO compliance.

## POLICY OBJECTIVES AND ACTION RECOMMENDATIONS

It will be important for the president and his team to define with clarity the policy choices and goals in U.S. relations with China. These must include both a public and a private agenda on WTO objectives.

*Major U.S. objectives are twofold: compliance and enforcement.* This means 1) achieving agreement on the timely application of WTO commitments; 2) working to help China develop

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mechanisms for bringing these policies into effect; and 3) encouraging China to create and support policies and structures that deliver the results promised in WTO commitments. Meeting these objectives will require the coordinated efforts of the U.S. administration, Congress, and the private sector, as well as other members of the world trade community.

*The WTO action program should, therefore, encompass the following measures.*

### **Administration Efforts**

The top priority for the administration must be to produce real gains for American interests. This will require building mutual confidence with an agreed agenda of “early harvest” accomplishments, engaging congressional and private-sector support for China’s WTO compliance efforts at the outset, and reinforcing the pace and direction of China’s reforms.

- *Produce real gains for American interests in real time, even as the United States pursues long-term goals.* In several respects, the integrity of the WTO system, as well as its role in promoting market-based reforms, is on trial in China’s WTO membership. It is essential to larger U.S. trade-policy goals that the major WTO players—the European Union, Japan, and the Cairns Group—exercise leadership to support China’s compliance and an expeditious dispute-settlement process. This is not solely a U.S. obligation, and the United States should avoid becoming the only demander.
- *Build mutual confidence with an agreed agenda of “early harvest” accomplishments.* Working closely with Chinese officials, the United States should develop a short, achievable list of agreed WTO commitments—and possible new initiatives not covered by the WTO—that could be put in place very soon to provide momentum in the implementation of China’s WTO obligations. In some cases, these might be done ahead of schedule. A confident, effective series of early implementation

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measures would go a long way toward establishing China's bona fides on the WTO and building a reservoir of goodwill before the more problematic phase-ins occur. Cynicism about the real gains from agricultural liberalization would be reduced by significant agricultural purchases coupled with offerings of new, high-quality, joint-venture opportunities in this sensitive sector. There may be important opportunities in the information and telecommunications sectors: a new telecommunications law including a larger role for foreign participation in both basic telecommunications and the Internet is being drafted; a new law allows cable companies to offer telecommunications services; and recent developments with the News Corporation and AOL Time Warner indicate that domestic broadcasting is opening to foreigners.

- *Engage congressional and private-sector support at the outset in the management of expectations about what is likely with respect to China's WTO compliance efforts.* Little about China's WTO compliance is likely to be easy, simply because of the nature of the challenges China faces. Managing U.S. expectations is among the foremost challenges for Washington. Corporate interests have moved their focus from MFN and PNTR to issue-specific compliance. Correspondingly, congressional supporters (and critics) of the relationship will press for validation of their efforts—or look for evidence of failure. Experience with GATT/WTO and the Israel and NAFTA agreements teaches that bringing responsible congressional committees into the process in an active fashion pays dividends in coping with the inevitable turbulence. Also, it would be a mistake to assume that corporate support for the China relationship is a bottomless well. Government and the private sector share a responsibility for the active oversight of WTO compliance in ways that strengthen Sino-American relations. This may mean augmenting the traditional sectoral advisory process (the Industry Sector Advisory Committee network) with a more proactive approach. The Congressional-Executive Commission on China could play an important role in providing accountability and focusing oversight of China policy in a productive direction.

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- *Reinforce the pace and direction of China's reforms.* This alliance of U.S. administration, congressional, and private-sector actors should support interest-based constituencies inside China that see WTO implementation as a key element in the broader and already ongoing reform process. This should take place across ministries and among opinion leaders in China and, to the extent possible, in the public imagination at large. It will involve working closely with Chinese officials and interested stakeholders—universities and ministry-tied think tanks—to build the capacity to educate and encourage provincial and local officials involved in grass-roots implementation of WTO policies. The WTO itself is hobbled by the fact that it has no resources to support trade adjustment or to cope with the developmental shocks that increased foreign competition will create in China. The United States and other members of the world trade community, buttressed by international organizations (such as the World Bank, the International Monetary Fund, and the Asian Development Bank), will need to cooperate with Chinese governmental and non-governmental actors to help address difficult adjustment problems. This will enable them to sustain WTO disciplines, even as increased competition intensifies the stress on the Chinese system.

Beyond these first-order objectives, the administration should also tackle several more narrow but significant challenges:

- *Achieving benefits that reach across sectors prior to, but not as a substitute for, addressing industry-specific problems.* Given the need to concentrate U.S. resources on immediate priorities, this means individual tariff issues or discrete market-access problems will receive less attention at the outset than systemic problems with respect to, for instance, the application of rules, such as national treatment. It would be a mistake to elevate too many specific issues at the outset, when broader and deeper gains are available through support for structures and practices that deliver meaningful changes to benefit a host of U.S. market participants.

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- *Minimizing manipulation of existing versus new U.S. entrants in the China market.* As WTO disciplines are given effect, divisions within the U.S. corporate community are likely to develop, notably between those already inside the China market and potential new entrants. Chinese policymakers have proven adept at playing competitors (and government actors) off one another. The administration must stress to China the importance of equal treatment for new and established entrants.

Finally, as the administration pursues each of the above objectives, it must continue to place the trade relationship within the context of the overall relationship:

- *Using trade to reinforce the other elements of the bilateral agenda, not weaken them.* WTO issues intersect with a range of other concerns in the U.S.-China relationship. Labor and environmental issues are closely related to trade and investment considerations. Sales of weapons and sensitive equipment are often driven by a combination of foreign policy and economic factors. China's national debates over environmental policy (already active) and labor rights (nascent) involve complex policy trade-offs for both the United States and China that must be addressed. Human rights practices are a reflection of the degree of predictability in the legal environment of the country and may well influence investment choices by U.S. businesses. The interplay of security issues as well as socioeconomic issues with WTO implementation requires consistent American attention and hitherto unattained coordination among the responsible U.S. agencies. Policies, and the discussions about them, have to be adapted to changing circumstances. Quiet confidence-building measures may succeed where public criticism has failed. And the United States cannot press China on all fronts at the same time and expect to succeed. Antiterrorist cooperation will provide an added reason to avoid applying pressure indiscriminately. The need to move from a laundry list of complaints to a choice of priorities in the overall relationship acquires a new importance. It will also require U.S. willingness to respect China's concerns about aspects of U.S. trade policies it considers harmful to its interests.

## **The Role of Congress**

- *Utilize the specialized congressional commissions on China to make China's WTO participation work for American interests.* PNTR has eliminated annual trade-status reviews, which included a human rights report and an overview of bilateral relations. The Levin-Bereuter amendment assured passage of PNTR but also created a new Congressional-Executive Commission on China. This commission could be a force for change or another forum for uncertainty and mutual recrimination. Congressional commissions outside the established committees have an uneven record of accomplishment. This requirement for regular discussions about human rights, labor, and religious freedoms could foster dialogue with China and support a search for openness and accountability that builds on Chinese experiments with an expanded rule of law. If, on the other hand, the discussions become an exercise in ritual public criticism, neither the United States nor China will benefit. Chinese and American officials need to recognize the importance of the Congressional-Executive Commission on China and make the most of this opportunity for a genuine and mature dialogue on issues that are central to American and Chinese concerns, without which a foundation of mutual trust will never exist. The commission should also be a focal point of executive branch efforts to work with Congress. One lesson of the past twenty-five years is that the executive branch, through its leadership, will have a crucial role in supporting successful congressional involvement.
- *Remove the remaining impediments to U.S. trade and technical assistance.* Normalizing trade with China requires an end to the remaining U.S. government-imposed restrictions on government trade-financing and insurance programs, such as the ban on U.S. support for environmental programs in China through the U.S.-Asia Environmental Partnership. Congress should also encourage the president to grant a presidential waiver in support of reinstating Overseas Private Investment Corporation assistance to China, along the same lines as the previous pres-

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idential waiver that returned Trade and Development Agency support to China.

### **Private-Sector Leadership**

- *Use vehicles outside of government channels to encourage the development of a culture of compliance with those who share the commitment.* Corporations, national and international trade associations, and technical bodies must be prepared to commit time and resources to supporting China's efforts at compliance through: technical guidance; training and "train the trainer" programs in their areas of specialty; and funding and building constituencies within China so China can develop its own capabilities. To the extent possible, U.S. interests should work with and through counterparts in the European Union, Canada, Japan, and Australia to achieve these objectives.
- *Develop dispute-resolution alternatives that rely on private actors and informal government participation to avoid overloading the WTO process.* The United States and other WTO members must avoid premature resort to the formal WTO dispute resolution process in responding to shortcomings in, or differences in opinion about, Chinese trade practices or China's concerns about the policies and actions of other WTO members, including the United States. There is a case to be made for developing alternatives (perhaps bilateral) to formal dispute resolution. Adaptations of existing bilateral meetings may provide a basis for reviewing complaints. Alternatively, creation of a wholly new structure might be a better option. For instance, the U.S./Japan Structural Impediments Initiative (SII) created industry-regulatory task forces in which first-order disputes were dealt with by groups of companies from both countries involved in the sector, as well as by both sets of regulators. In general, resort to dispute resolution should be understood as a last resort. It should, as a matter of multilateral understanding, be reserved for those China cases that involve core issues of compliance.

## ADDITIONAL VIEW

In addition to the excellent recommendations in this report, I would like to offer some additional thoughts on China's WTO accession.

There are three important aspects to helping China enforce trade agreements. The first is regular visits by informed people (those knowledgeable about both the WTO and China) to transform events into action by continuing to make the arguments on why enforcement is important. Just as important is the construction of an international coalition within the WTO so this is defined not just as a U.S.-China issue, but also as a multilateral issue. The third ingredient is private-sector and government assistance in implementing agreements, such as training programs, educational programs on the WTO, visits to the United States for training, and so on. These suggestions are, of course, in addition to turning to dispute settlement and other, more formal channels.

As a result, I suggest that the group also consider recommendations that include the following: a commitment from the Office of the U.S. Trade Representative (USTR) that its China office will take on significant enforcement activities, and that the USTR will consider temporarily stationing someone in China, perhaps for one year, to assist with implementation in the early stages; having the United States take the lead in organizing a group of WTO members to visit China on a fact-finding mission to review implementation as a group (this group would not draw conclusions—that is up to the individual member states—but would simply present the facts on implementation); and placing implementation within the much larger context of both overall U.S. trade policy with China as well as U.S.-China relations.

Our trade agenda with China must be much broader than just implementation of the WTO agreement, although that is clearly a major job in its own right.

*Deborah M. Lehr*

## DISSENTING VIEW

While the report intends to focus on China's implementation of its commitments to the WTO and U.S. policy considerations growing out of this process, it does so too narrowly. Our bilateral relationship with China, and China's own policies concerning WTO implementation, cannot be divorced from many other economic, political, and military considerations. The report does not address these in a meaningful way. Therefore, the report's assumptions and conclusions about the primacy of trade and investment in formulating U.S. foreign policy are more polemical than reasoned.

It remains arguable whether China can fully implement a WTO agreement likely to have a number of serious effects upon significant segments of its population. While the report alludes repeatedly to problems such as unemployment among farmers and workers, it is silent on U.S. policy options should the Chinese government use massive repression as a tool of WTO implementation.

For all the mentions of increasing pluralism throughout the report, the fact remains that despite "pressures," the ruling Communist Party has exhibited no inclination to allow the creation of institutions that commonly comprise civil society. China's continued refusal, for instance, to allow the creation of independent trade unions represents a clear policy decision that repression is preferred to negotiation with workers on matters directly affecting the government's interests. This conclusion is further reinforced by the increasing size of the People's Armed Police, the force frequently employed to re-press workers and farmers who strike or demonstrate to air their grievances.

The report implicitly argues that China's entry into the WTO will help political pluralism develop within China. Such arguments about trade generally have been made for the past decade with scant evidence that pluralism is either an unintended outcome or an intended goal of Chinese economic reform. On the contrary, there is ample

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evidence in both word and deed that Chinese leaders place their highest priority on the maintenance of a one-party state and will continue to do so.

The report mentions the need for the Chinese government to address corruption and judicial reform—issues of clear importance to business interests—but does not explicitly deal with the equally important issue of the free association of people, thus reinforcing the Chinese government’s mistaken belief that it can and should maintain one-half of a free market system. While such omissions are understandable from a narrow, business point of view, they render the report, and its otherwise strong analytical basis, less useful for U.S. policymaking.

*Jeffrey L. Fiedler*

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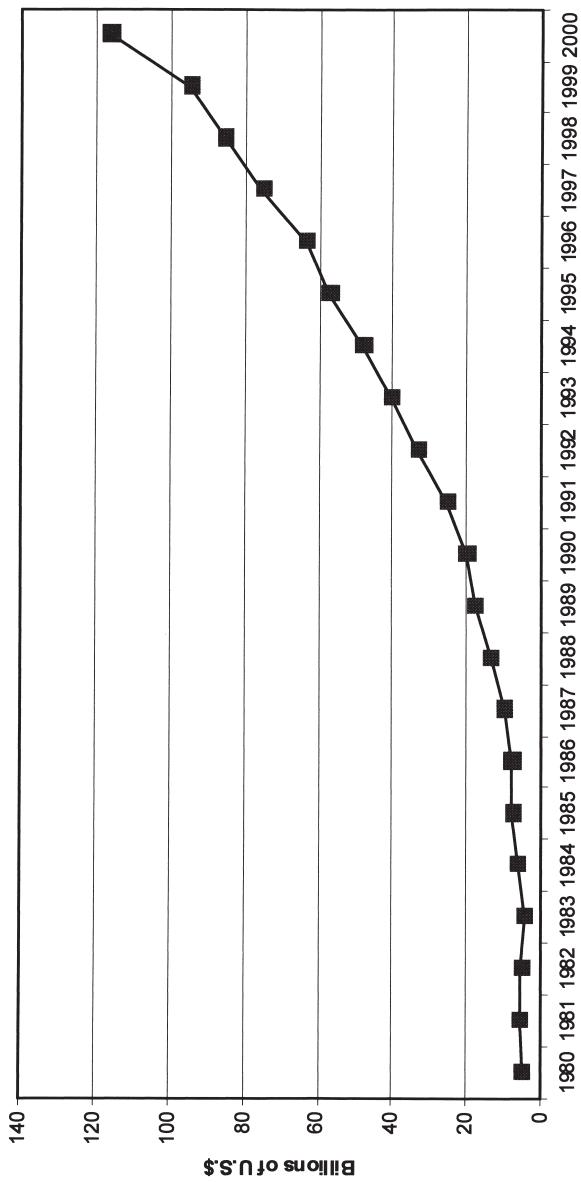
\*\*Individual did not endorse the report and contributed a dissenting view.

## APPENDIXES

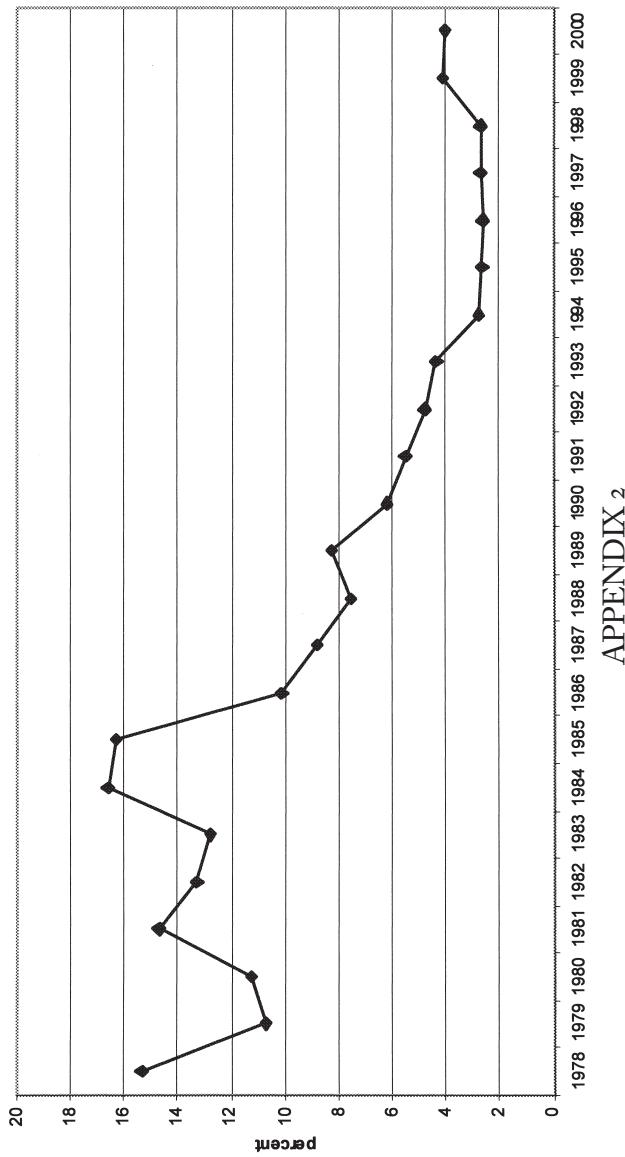


## APPENDIX 1

U.S. -China Bilateral Trade, 1980-2000



Source: Nicholas R. Lardy, *China in the World Economy* (New York: Institute of International Economics, 1994), with updated information from Lardy, available at [www.uschina.org/public/wto/](http://www.uschina.org/public/wto/)



## *Appendices*

### APPENDIX 3

#### TAIWAN'S WTO MEMBERSHIP AND U.S. INTERESTS

China-Taiwan relations may be the ultimate test of the power of economic globalization when confronted with traditional enmity. Both Beijing and Taipei may have underestimated the challenges of having both governments inside WTO disciplines. Taiwan applied for WTO membership as the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu, thus avoiding the issue of Taiwan's sovereignty. The unspoken bargain has been that Taiwan's membership would follow immediately that of China, though there was no legal necessity for such a delay. The WTO working party on Taiwan's membership reached agreement on essential terms several years ago, and in September 2001 negotiations were concluded for Taiwan to enter the WTO.

In considering the implications of their joint membership, both Beijing and Taipei reassure themselves that little will change because political realities will govern economics, and neither government has agreed to a formula for coexistence after Taiwan's democratic elections and the end of the Kuomintang government's fifty-year reign. Beijing and Taipei take confidence in their ability to control economic relations in the context of political realities. For Beijing, this state of affairs means the reintegration of Taiwan inside of "one China"; for Taipei, it requires guarantees of Taiwan's "political space" and self-determination.

Taiwan's investment in mainland China now is estimated at over \$50 billion, with some two-thirds of the total overseas money in the vibrant coastal provinces of Guangdong and Fujian coming from Taiwan. Two-way trade exceeds \$30 billion annually (see Appendix 4). Taiwanese investment is an important source of job creation and support for the local tax base on the mainland; mainland China has become a critical production platform for Taiwan's electronics industry.

The growing vested interests are reflected in a progression of policy changes. First, Taiwan adopted the "three small links" policy. Improved cooperation in direct postal service, trade, and

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transport has further disassembled barriers to movements of people and products. In January 2001, a ferry connected mainland China with the outer Taiwan islands for the first time since 1949. Taipei recently adopted a new set of policies toward investment on the mainland and regarding mainland investment in Taiwan. The Taiwanese purchase of 25 percent of China Eastern's air cargo division and a joint venture between a Taiwanese firm and the China National Offshore Oil Corporation (CNOOC), a mainland state-owned oil firm, hint at qualitative changes in the cross-strait economic relationship that are likely to be fostered once both are in the WTO. A November 2000 survey of Taiwanese elites found that 93 percent believe the WTO will be helpful or very helpful in reducing cross-strait tensions. Most important, Taiwan's president, Chen Shui-bian, has said that shared WTO obligations should open the way to complete economic normalization.

Economic interests, which are increasingly independent from the governments in both mainland China and Taiwan, will pursue greater trade and investment opportunities in the wake of WTO accession that will test the political boundaries on cross-strait relations. "Why should Chinese treat trade and investment by other Chinese less favorably than they treat Americans, Italians, or Canadians?" Beijing and Taipei will be pressed to answer that question.

WTO membership occurs as both sides have begun to show flexibility in imagining new formulas for association. President Chen has set aside his Democratic Progressive Party's insistence on independence for Taiwan, and China's vice premier, Qian Qichen acknowledges that the "one China" formula does not presuppose Beijing's governance, hinting that discussions with Taiwan should proceed as a conversation between equals.

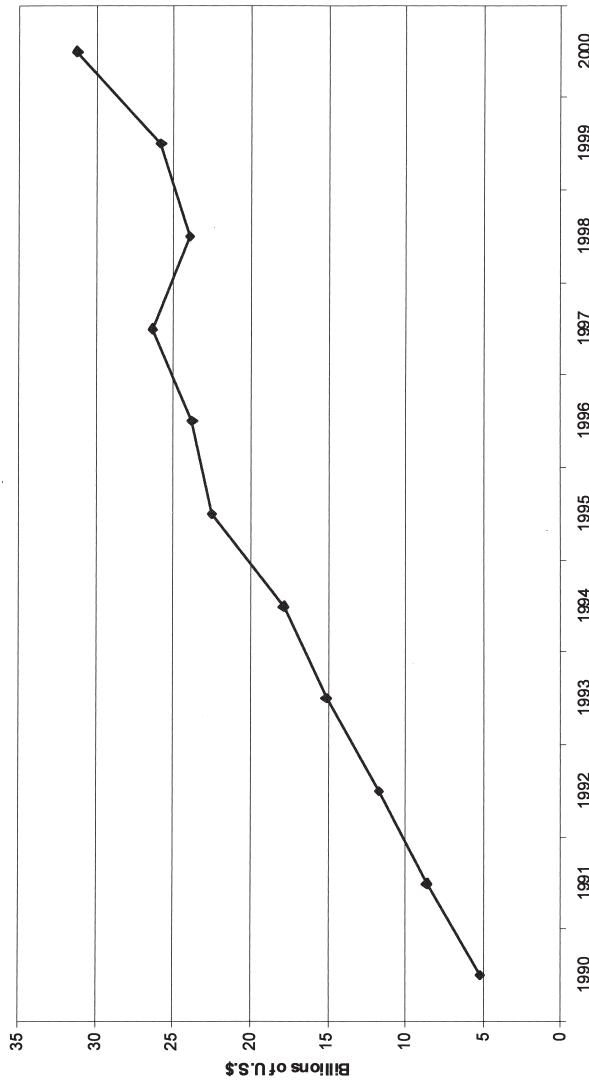
None of this is to say that the pressures for increased integration are irreversible. There is a risk that the politics of shared WTO obligations could become a new arena for traditional tensions if either party elects to use WTO commitments as a point of contention rather than as a tool for mutual interest.

## *Appendices*

American officials should recognize concurrent WTO membership as an important step in a process of discovering a new modus vivendi for mainland China and Taiwan—one that could alter the cross-strait equation. Such a process is not without risk to the United States. Closer economic ties between the mainland and Taiwan, for example, may well include greater integration in businesses fundamental to U.S. national security, such as high technology, thus raising new questions for U.S. export controls. Yet even as the United States remains watchful about such security concerns, it should welcome trade's role in reducing cross-strait tensions.

## APPENDIX 4

Total Cross-Straits Trade, 1990-2000



Source: The Republic of Taiwan Yearbook (Taiwan: Government Information Office, 1989-2000).

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# BEGINNING THE JOURNEY CHINA, THE UNITED STATES, AND THE WTO

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## REPORT OF AN INDEPENDENT TASK FORCE SPONSORED BY THE COUNCIL ON FOREIGN RELATIONS

China's entry into the World Trade Organization (WTO) will offer considerable economic benefits both for China and the United States, as well as the opportunity to make progress on economic, security, and political issues in the Sino-American relationship. At the same time, China's transition into the WTO poses significant challenges for both countries. For China's leaders, the chief challenge is implementing a sweeping and unprecedented set of economic reforms in a number of key sectors, while simultaneously managing the social dislocation and unrest that such reforms will engender. For the United States, the greatest risk lies in a political backlash if China's entry into the WTO does not produce immediate benefits to American workers and industry or significantly reduce China's trade surplus with the United States. This Independent Task Force Report underscores these problems and addresses how cooperation between the United States and China on trade issues can improve the prospects for U.S.-China relations in general.

The report specifically recommends that U.S. leaders should undertake the following steps: target a few high-profile WTO commitments for early implementation to build mutual confidence, stress multilateral approaches to encourage China's compliance, and support China's overall efforts to develop market-based rules through greater financial and technical assistance. In addition, it argues that a realistic, determined, and supportive approach by the United States to China's WTO implementation can do more to shape China's economic and political priorities than any other policy choice in recent history.

The Task Force included a bipartisan group of individuals with extensive China experience, including former U.S. government officials, business leaders, policythinkers, and academics.

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